

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission	:	
On Its Own Motion	:	
-vs-	:	00-0720
The Peoples Gas Light and Coke Company	:	
Reconciliation of revenues collected under	:	
fuel and gas adjustment charge with actual	:	
costs.	:	

ORDER

By the Commission:

On November 8, 2000, the Illinois Commerce Commission ("Commission") entered an Order Commencing PGA Reconciliation Proceedings, in accordance with the requirements of Section 9-220 of the Public Utilities Act, which directed The Peoples Gas Light and Coke Company ("Peoples Gas," the "Company" or "Respondent") to present evidence in this docket at a public hearing to show the reconciliation of Respondent's purchased gas adjustment clause ("PGA") revenues collected with the actual cost of such gas supplies prudently purchased for the twelve months ended September 30, 2000, Respondent's fiscal 2000 year.

In compliance with the Commission's Order in this proceeding, notice of the filing of Respondent's testimony and exhibits was posted in Respondent's business offices and was published in newspapers having general circulation in Respondent's gas service territory in the manner prescribed by 83 Ill. Adm. Code Part 255.

Pursuant to notice given as required by law and by the rules and regulations of the Commission, an evidentiary hearing was held before duly authorized Administrative Law Judges ("ALJs") of the Commission at the offices in Chicago, Illinois on August 28, 2001. The People of the City of Chicago, (the "City") the Citizens Utility Board ("CUB") the Attorney General's Office (the "AG") and ("CCSAO") each filed petitions to intervene, which were granted. At that hearing, appearances were entered by the Respondent, Commission Staff, the City, the AG, CUB and the CCSAO.

The Company presented the direct testimony of Valerie H. Grace and David Wear and the rebuttal testimony of Mr. Wear. Staff presented the direct testimony of Garret E. Gorniak and Steven A. J. Cianfarini. The City presented the direct and rebuttal testimony of Dr. Robert J. Michaels. At the conclusion of the hearing on August 28, 2001, the record was marked "Heard and Taken."

OVERVIEW

The record contains detailed and comprehensive reconciliations of the revenues collected by the Respondent under its PGA and the actual cost of purchased gas recoverable under the PGA for the reconciliation period. Neither Staff nor any other party objected to the Respondent's reconciliation of costs and revenues. The record also contains evidence pertaining to the prudence of Respondent's purchases of natural gas. Staff testified that it found no evidence of imprudence on the part of the Respondent. The City contended that the Commission should find that Respondent was imprudent for not using financial hedging instruments during the reconciliation period. The City did not propose a gas cost disallowance. The Respondent offered testimony establishing that its decision not to use financial hedging tools was not imprudent and the City's proposal was inconsistent with the evidence in the record and Commission policy.

PRUDENCE OF PURCHASES

Peoples Gas' Position

Mr. Wear, Peoples' Manager of Gas Supply Administration, testified as to Peoples Gas' fiscal 2000 gas supply and capacity procurement procedures. He stated that those procedures were used to help ensure that Peoples' gas supply costs for its fiscal year 2000 reflected continuing efforts to minimize those costs, consistent with operational and contractual constraints and the statutory obligation to provide adequate, reliable and safe service to customers during all periods of the year. He also testified that Peoples had various firm gas supply contracts providing for both citygate and field deliveries. Mr. Wear additionally testified that Peoples purchased gas on a non-firm basis. Gas purchased in the field was transported to the citygate or for injection into storage using transportation contracts with pipelines. He further testified that the Company had storage contracts with two pipelines and one non-pipeline service provider as well as a storage field that it owns and operates. Mr. Wear described the various steps that Peoples took to ensure that the pipelines serving it provide reliable service. Mr. Wear also described the various steps the Respondent took to monitor contract compliance by pipelines and suppliers.

Staff's Position

Staff witness Steven Cianfarini, a Senior Energy Engineer in the Engineering Department of the Energy Division, testified as to the Commission's definition of "prudence." He then stated that, after reviewing the Company's testimony and responses to extensive data requests, he did not find that the Respondent made any imprudent purchases. He also recommended that, in the future, the Respondent should consider purchasing a portion of its gas supply with contracts that are not tied to index pricing. Mr. Cianfarini opined that the Company should weigh the benefits and risks of non-index pricing, and then develop an appropriate strategy.

The City's Position

City witness Dr. Robert Michaels, a Professor of Economics at California State University, described the evolution of hedging, a strategy that reduces the risks associated with price volatility, in the gas industry. Dr. Michaels stated that many competitive gas market participants wish to insulate themselves from unpredictable price fluctuation and they do so by actively managing their gas storage and they trade a wide variety of financial instruments, such as futures, options, and "swaps." Dr. Michaels also testified that currently, financial hedging instruments are widely used by participants in the gas market, except local distribution companies, ("LDCs") which have been slow to use financial hedging instruments. In Dr. Michaels' opinion, this slowness is probably because most LDCs recover their gas costs through a PGA.

Dr. Michaels additionally testified that, in addition to financial hedging, there are other ways to reduce the risk of gas price increases, such as diversification and physical hedging through the use of tools such as storage. A hedging strategy should incorporate both physical and financial hedges, in Dr. Michaels' opinion. Dr. Michaels also opined that, although physical hedges, the hedging mechanisms used by Peoples, are an important component of a prudent hedging strategy, alone, physical hedges could not moderate all risks. According to Dr. Michaels, financial hedges are such a valuable and common tool in managing the risks associated with price volatility, it is difficult to imagine a situation in which a company would not use such a hedge.

Dr. Michaels further testified that failure to purchase financial hedges is not *per se* imprudent, a prudent risk management program may indicate that, at certain times, a company should decrease its hedged positions. He opined that the use of a financial hedge is a complex matter, which requires examination of numerous factors.

Dr. Michaels stated that generally, the use of financial hedging could result in customers paying higher prices than what they would pay if no financial hedging were in place. According to Dr. Michaels, the use of financial hedging instruments is "no more speculative" than non-use of financial hedges.

Dr. Michaels also stated that Peoples did not use financial hedging instruments during the reconciliation period. In Dr. Michaels' opinion, gas prices were volatile in between the Spring and Winter of 1999. He commented that the Spring of 1999 was the time period in which Peoples stated that it planned its purchases for the Winter of 1999-2000. He concluded that, in light of the market data Peoples had available to it, Peoples should have engaged in a prudent hedging strategy that incorporated financial hedges, and Peoples' failure to incorporate financial hedges during the reconciliation period was imprudent. Dr. Michaels did not estimate any "overcharges" or "damages" resulting from Peoples Gas' decision not to hedge financially.

Peoples Gas' Response

Mr. Wear agreed with Staff's recommendation concerning the future consideration of non-index pricing for a portion of its supply. Mr. Wear described the Respondent's extensive storage resources, which contribute to price stability and service reliability. He then testified that the Respondent carefully monitored futures prices for the 1999-2000 winter season and observed little volatility, which the Respondent defined as rapid, unpredictable and short-lived price fluctuations. Mr. Wear also noted the Respondent's view that there was some ambiguity regarding the Commission's policy on the prudent use of financial instruments.

The City's Response

In response, the City presented the expert testimony of Dr. Michaels, who stated that in his opinion, failure to use financial hedging was not *per se* imprudent. Dr. Michaels also testified that physical hedges were only one component of a hedging strategy and, alone, were not a prudent hedging strategy. He repeated his assertion that there was price volatility during the reconciliation period and discussed the economic analysis underlying his assertion.

GAS RECONCILIATION

Peoples' Position

Ms. Grace, Respondent's Director of Rates and Gas Transportation Services, presented a reconciliation of the Company's total gas revenues with total gas costs for the reconciliation period October 1, 1999, through September 30, 2000. (Exhibit A, attached hereto). Ms. Grace addressed each of the fourteen data elements identified in the Commission's November 8, 2000 order and stated that the Reconciliation Statement is accurate for each of Respondent's gas charges.

The Respondent presented an independent reconciliation for each of the following: Commodity Gas Charge, Non-Commodity Gas Charge and Demand Gas Charge, and Transition Surcharge. Below is an aggregation of those reconciliations.

1. Unamortized Balance at 09/30/99 per 1999 reconciliation (Refund)/Recovery	\$ 3,497,621.72
2. Factor A Adjustments Amortized to Sch. I at 09/30/99 per 1999 reconciliation (Refund)/Recovery	4,577,488.79
3. Factor O (Refunded)/Recovered during 2000	0.00
4. Balance to be (Refunded)/Recovered during 2000 from prior periods	8,075,110.51
5. 2000 PGA Recoverable Costs	452,546,073.99
6. 2000 PGA Actual Recoveries	417,175,275.68
7. Interest	352,271.79

8. Other Adjustments	0.00
9. Pipeline Refunds	(177,817.95)
10. (Over)/Under Recovery for 2000	35,545,252.15
11. PGA Reconciliation Balance at 09/30/00 (Over)/Under Collected	43,620,362.66
12. Factor A Adjustments unreconciled at 09/30/00 (Refund)/Recovery	13,153,581.51
13. Unamortized Balance at 09/30/00 (Refund)/Recovery	30,466,781.15
14. Requested Ordered Reconciliation Factor to be (Refunded)/Recovered [Factor O]	0.00

Staff's Position

Staff witness Garret Gorniak, an Accounting Supervisor in the Accounting Department of the Financial Analysis Division, described his detailed review of Respondent's PGA reconciliation and underlying documents and workpapers supporting the calculations. Mr. Gorniak stated that he found no reason to object to the Company's reconciliation of revenues collected under the PGA with the actual cost of gas supplies. He recommended that the Commission accept the reconciliation of revenues collected under the PGA clause with actual costs as shown in Respondent's Exhibit 1.

COMMISSION ANALYSIS AND CONCLUSIONS

The record herein contains a detailed description and review of Respondent's PGA revenues collected with actual costs for such gas supplies prudently purchased for the twelve month period that ended on September 30, 2000. All parties were afforded the opportunity to conduct discovery, cross-examine all witnesses, and present any evidence with respect to any issue in this proceeding.

Prudence of Purchases

Respondent presented detailed evidence in support of the prudence of the gas costs that it recovered through its PGA during the reconciliation period. In evaluating this evidence, Staff used the appropriate standards adopted by the Commission to review prudence, and found no evidence of imprudence. Neither Staff nor any party recommended a gas cost disallowance. However, the City asserted that the Commission should find that the Respondent was imprudent because it decided not to use financial hedges during the reconciliation year. Consequently, the only question before the Commission is whether Respondent's decision not to use financial hedges to mitigate price volatility was imprudent.

The Commission defines prudence as follows:

Prudence is that standard of care which a reasonable person would be expected to exercise under the same circumstances encountered by utility management at the time decisions had to be made. In determining whether a judgment was prudently made, only those facts available at the time judgment was exercised can be considered. Hindsight review is impermissible.

Imprudence cannot be sustained by substituting one's judgment for that of another. The prudence standard recognizes that reasonable persons can have honest differences of opinion without one or the other necessarily being 'imprudent'.

(See, e.g., Illinois Commerce Commission v. Commonwealth Edison Company, October 7, 1987, Docket 84-0395, p. 17).

The City's recommendation hinges on its testimony that there was price volatility during the reconciliation period, from which, it concluded that Respondent should have used financial tools to mitigate that volatility. The evidence presented by the Respondent, however, indicates that the Respondent was not of the opinion that there was any such volatility. The Respondent also presented evidence establishing that it made extensive use of physical hedging, including storage, to manage gas costs and provide reliable service.

Even if we assume that there was price volatility, and we make no finding on this point, the Commission has previously found that, while mitigating volatility is one aspect of gas supply planning, it is not an end in itself. In the past, the Commission has declined to create an obligation or responsibility to mitigate price volatility through the use of financial tools. (Illinois Commerce Commission v. Peoples Gas Light and Coke Company, January 26, 2000, Docket 97-0024, p. 7). We agree with the City and the Company that the use of financial hedging instruments requires the consideration of numerous factors, of which, price volatility is only one. The City has failed to show that the gas supply tools that the Respondent did choose to use were inadequate to prudently control gas costs while providing safe and reliable service. At best, the Commission is presented with "honest differences of opinion" and finds that there is no basis for substituting the City's judgment for the Respondent's on the issue of using financial instruments.

In its Brief on Exceptions, the City contends that there is no real "honest difference of opinion" with regard to the use of financial instruments because, according to the City, the evidence regarding price volatility in the Spring of 1999 was almost completely in its favor. (City Brief on Exceptions, p. 4). This argument overlooks the reasoning cited above, as we made no finding as to price volatility. Rather, we found, in essence, that even assuming that there was price volatility, the evidence the City

presented did not establish that the Respondent's failure to use financial hedging instruments was imprudent.

Also in its Brief on Exceptions, the City argues that the Commission should find that the Respondent's gas purchases were imprudent, irrespective of the fact that no evidence was presented as to how much money, if any, could have been saved by using financial hedging instruments. The City opines that the evidence presented established that there was great price volatility in the Spring of 1999, and it also established that the Respondent was imprudent, regardless of whether there was any evidence that Respondent could have saved any money. (City Brief on Exceptions, pp. 1-2).

This contention misses the point. The thrust of the City's argument at the hearing was that the Respondent was imprudent by failing to use financial hedging instruments to mitigate price volatility. Yet, there was no evidence presented establishing how much money, if any, the Respondent could have saved by using financial hedging instruments. Without evidence establishing that some savings would have occurred, it is difficult to find that any savings could have been accomplished.

Citing People ex rel. Hartigan v. Ill. Commerce Commission, 117 Ill. 2d 120, 135, 510 N.E.2d 865 (1987), the City additionally argues that if the Commission finds that the Respondent was imprudent for failure to use financial hedging instruments, then, the Commission should have determined what imprudent costs should be refunded to the ratepayers. (City Brief on Exceptions, p. 3). This reasoning misses the point made in the Proposed Order, that without evidence as to what amount, if any could have been saved through the use of financial hedging instruments it is difficult to conclude that failure to financial hedging instruments was imprudent. The City's reasoning also overlooks the fact that the proposed order concludes that the Respondent's gas purchases were not imprudent. Without a finding of imprudence, logically, there is no need for a determination as to what imprudent costs should be refunded.

The Commission additionally notes that Hartigan does not support the City's position. In reversing a rate matter, the Court noted that ratemaking is a legislative function. That Court concluded, in essence, that the Commission erred in concluding that there was no evidence presented indicating that certain costs should not be in the rate base because there, in fact, was evidence indicating that those costs should be disallowed. The Court also concluded that the Commission erroneously presumed that the utility's costs were reasonable. (Hartigan, 117 Ill. 2d at 120).

We disagree with the city's contention that the Court in Hartigan required the trier of fact to reach outside the evidence presented. Rather, we read Hartigan to require the trier of fact to reach outside the evidence presented, as the City suggests. Instead, Hartigan requires the trier of fact to consider the evidence before it and apply the correct legal standard to that evidence.

The Commission agrees that the use of financial tools can be a way to mitigate gas price volatility, and it concurs with the Staff recommendation that Respondent should consider the use of non-index based pricing in a portion of its future gas supply agreements. While the Commission continues its policy of not *requiring* utilities to use financial tools, it has recently stated that it does not want to preclude utilities from implementing prudent hedging strategies to reduce price risk for customers. The Commission recognizes that financial hedging does not guarantee lower costs in either the short-run or in the long-run; however, when used wisely, financial hedging can reduce exposure to price variations, which has advantages and disadvantages for consumers.

In addition to the reasons set forth above, the Commission thus disagrees with the City that it should find that Respondent was imprudent for choosing not to use financial hedging instruments during the reconciliation year. As even Dr. Michaels conceded, it is not *per se* imprudent not to use financial instruments. Moreover, as was mentioned earlier, the City presented no evidence as to the amount of money the Respondent could have saved, had it embarked on a strategy involving the use of financial hedging instruments. Without such evidence, it is difficult to ascertain what savings, if any, could have been achieved.

In its Brief On Exceptions, the City contends that the citation above to Dr. Michaels' testimony is taken out of context. The City argues, in essence, that Dr. Michaels' testimony, when taken in its totality, requires a finding that the Respondent was imprudent. (City Brief on Exceptions, p. p. 5-6). Yet, the City acknowledges that in the very next sentence, Dr. Michaels stated, "A prudent risk management program may indicate that, at certain times, a company should decrease its hedged position conceivably to zero." (*Id.*). Dr. Michaels' testimony, in fact, supports the Commission's view that it is the hedging strategy utilizing financial hedging instruments that must be analyzed to determine prudence, not just whether a utility uses such hedging instruments. Here, there was no evidence as to what strategy, if any, could or would have been used.

The Commission notes that in the past, we have discouraged the use of some financial hedging instruments when the hedging strategy implemented in acquiring those instruments increased the price risk for the ratepayers. (Illinois Commerce Commission v. Central Illinois Light Co., 1998 Ill PUC Lexis 383 at 17-20). It was not the use of financial hedges that the Commission discouraged; rather, it was a particular method used, or a "hedging strategy" in acquiring those financial instruments, that the Commission found to be problematic. (*Id.*). Here, the City presented no evidence as to what strategy implementing financial hedges, if any, would be an effective tool in the reduction of price volatility.

Finally, the City argues, in its Brief on Exceptions, that at the evidentiary hearing, the theory the City espoused went "completely unchallenged on the record." (City Brief on Exceptions, p. 5) This contention is simply incorrect. Our review³ of the record

reveals that Peoples' cross-examination of Dr. Michaels revealed numerous flaws in the theory espoused by the City, such as the fact that the use of financial hedging instruments could result in customers paying higher prices; it is not necessarily imprudent not to use financial hedging instruments; or the fact that Dr. Michaels did not know whether any of the gas utilities that he stated used financial hedging instruments had received prior approval from state regulatory commissions. (Tr. at 63, 68, 69, respectively). We conclude that this testimony, and other evidence, successfully challenged the City's arguments regarding prudence.

The Commission finds that Respondent's expenditures for the purchase of its gas supply during the reconciliation period ending September 30, 2000, were reasonable and prudent. Additionally, the Commission recommends that Respondent consider the use of non-index based pricing in a portion of its future gas supply agreements.

Gas Reconciliation

Respondent presented a detailed reconciliation of its gas costs and revenues for the reconciliation period and addressed each of the questions raised in the Commission's initiating order. Staff conducted a thorough review of Respondent's accounts, and analyzed workpapers and supporting data relied upon by Respondent. No other party presented evidence on this issue. The Commission finds that Respondent properly reconciled amounts collected through Respondent's PGA with prudently incurred actual gas costs. The Commission concludes that the 2000 Gas Charge reconciliation, as shown in Appendix A hereto, should be approved.

Additionally, the determinations made in this Order create no presumptions for future reconciliation proceedings, as to either the reasonableness of Respondent's gas expenditures in periods after 2000, or, the nature and scope of review thereof.

FINDINGS AND ORDERING PARAGRAPHS

The Commission, having given due consideration to the entire record and being fully advised in the premises, is of the opinion and finds that:

- (1) The Peoples Gas Light and Coke Company is a corporation engaged in the distribution of natural gas service to the public in Illinois and, as such, is a public utility within the meaning of the Public Utilities Act;
- (2) the Commission has jurisdiction over Respondent and of the subject matter of this proceeding;
- (3) the statements of fact set forth in the prefatory portion of this Order are supported by the evidence of record and are hereby adopted as findings of fact;

- (4) during the reconciliation period there was no evidence to indicate that Respondent had not acted reasonably and prudently in its purchases of natural gas;
- (5) the unamortized balances at the end of Respondent's 2000 reconciliation year show a recoverable balance for the Commodity Gas Charge of \$31,416,105.68; a refundable balance of \$936,949.00 for the Non-Commodity Gas Charge and the Demand Gas Charge; and a refundable balance of \$12,375.53 for the Transition Surcharge, for a total recoverable balance of \$30,466,781.15;
- (6) the reconciliations submitted by The Peoples Gas Light and Coke Company of the costs actually incurred for the purchase of natural gas with revenues received for such gas for the reconciliation period beginning October 1, 1999, through September 30, 2000, may properly be approved.

IT IS THEREFORE ORDERED that the reconciliations submitted by The Peoples Gas Light and Coke Company of the costs actually incurred for the purchase of natural gas with revenues received for such gas for the reconciliation period beginning October 1, 1999, through September 30, 2000, as shown in Appendix A hereto, be, and they are hereby, approved.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.880, this Order is final; it is not subject to the Administrative Review Law.

By Order of the Commission this 24th day of January, 2002.

Chairman

The Peoples Gas Light and Coke Company
Gas Charge Reconciliation Summary
Fiscal 2000

	<u>Commodity Gas Charge (CGC)</u>	<u>Non-Commodity Gas Charge and Demand Gas Charge (NCGC and DGC)</u>	<u>Transition Surcharge (TS)</u>	<u>Total Gas Charge</u>
<u>Line</u>				
Fiscal 1999				
1 Unamortized Balance at September 30, 1999 (Refund) / Recovery	\$4,087,601.80	(\$543,593.31)	(\$46,386.77)	\$3,497,621.72
2 Factor A Adjustments unreconciled at September 30, 1999 (Refund) / Recovery	4,703,078.31	(110,099.09)	(15,490.43)	4,577,488.79
3 Factor O (Refunded) / Recovered	0.00	0.00	0.00	0.00
4 Balance (Refundable) / Recoverable from Prior Periods (Line 1 + Line 2 + Line 3)	8,790,680.11	(653,692.40)	(61,877.20)	8,075,110.51
Fiscal 2000				
5 Costs Recoverable through the Gas Charge	394,835,201.49	57,710,872.50	0.00	452,546,073.99
6 Revenues Arising through Application of the Gas Charge	359,351,959.92	57,860,649.59	(37,333.83)	417,175,275.68
7 Separately Reported Pipeline Refunds or Surcharges	0.00	(177,817.95)	0.00	(177,817.95)
8 Separately Reported Other Adjustments	0.00	0.00	0.00	0.00
9 Interest Calculated at 5.50%	530,765.16	(177,158.97)	(1,334.40)	352,271.79
10 (Over) / Under Recovery for Reconciliation Year (Line 5 – Line 6 + Line 7 + Line 8 + Line 9)	36,014,006.73	(504,754.01)	35,999.43	35,545,252.15
11 (Over) / Under Recovery Balance for Reconciliation Year (Line 4 + Line 10)	44,804,686.84	(1,158,446.41)	(25,877.77)	43,620,362.66
12 Factor A Adjustments unreconciled at September 30, 2000 (Refund) / Recovery	13,388,581.16	(221,497.41)	(13,502.24))	13,153,581.51
13 Unamortized Balance at September 30, 2000 (Refund) / Recovery (Line 11 – Line 12)	\$31,416,105.68	(\$936,949.00)	(\$12,375.53)	\$30,466,781.15
14 Requested Factor O (Line 11 – Line 12 – Line 13) (Refund) / Recovery	0.00	0.00	0.00	0.00